

ANALYSIS OF AMENDED BILL

Author: Frommer Analyst: Gail Hall Bill Number: AB 1037
 Related Bills: See Legislative History Telephone: 845-6111 Amended Date: September 8, 2005
 Attorney: Patrick Kusiak Sponsor: _____

SUBJECT:	Net Receipts In Sales Factor For Treasury Function/Single Sales Factor For Qualified Business Activity
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SUMMARY

Under the Corporation Tax Law, this bill would do the following:

- define gross receipts and
- change the method used by companies in specified industries to calculate their California business income.

SUMMARY OF AMENDMENTS

The September 8, 2005, amendments added the single sales factor as a method of calculating state business income and made changes to the definition of business income and gross receipts arising from a treasury function.

The September 8th amendments resolved technical consideration number one in the department's analysis of the bill as amended April 7 and 12, 2005. Except for the discussion in this analysis, the remainder of the department's analysis of the bill as amended April 7 and 12, 2005, still applies.

PURPOSE OF THE BILL

The author's office has indicated the purpose of this bill is to define a previously undefined term to prevent potential manipulation of the franchise tax apportionment formula and to encourage certain industries to invest in California.

EFFECTIVE/OPERATIVE DATE

This bill is a tax levy and would be effective immediately upon enactment. This bill provides that the amendments relating to the treasury function¹ would become operative for taxable years beginning on or after January 1, 2006, and the amendments relating to the single-factor, 100 percent sales apportionment formula² (single sales factor), would become operative for taxable years beginning on or after January 1, 2007.

¹ Revenue and Taxation Code (R&TC) Section 25120

² R&TC Section 25128

Board Position:

_____ S	_____ NA	_____ NP
_____ SA	_____ O	_____ NAR
_____ N	_____ OUA	_____ X PENDING

Department Director

Selvi Stanislaus

Date

02/23/06

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

The Corporation Tax Law defines business income as income arising from transactions and activities in the regular course of the taxpayer's trade or business, and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. Nonbusiness income is defined as all income other than business income.

For taxable years beginning on or after January 1, 1993, the apportionment formula for most taxpayers has been a three-factor, double-weighted sales apportionment formula. (See the department's analysis of the bill as amended on April 7 and 12, 2005, for further discussion). An exception to this rule is taxpayers that derive more than 50 percent of their gross business receipts from conducting a "qualified business activity"; such taxpayers use a three-factor, single-weighted sales apportionment formula. A qualified business activity is defined as an agricultural, extractive, savings and loan, and banking or financial business activity.

State law permits a departure from the standard apportionment provisions only in limited and specific cases³, and recognizes that the standard apportionment provisions are not appropriate when applied to certain industries and types of transactions, and provide special apportionment procedures for those situations.⁴

THIS BILL

Treasury Function

This bill provides that income arising from the treasury function of the taxpayer's trade or business would always be classified as business income. This bill also provides that hedging activities relating to the business of the taxpayer would not be included in the definition of a treasury function activity. For example, if a taxpayer makes a product using wheat, and the taxpayer participates in hedging activities to reduce the risk of cost fluctuations of its wheat inventories (raw materials), these hedging activities would not be included in the definition of treasury function activities, and therefore, the income from these hedging activities would be included in the sales factor at "gross receipts" instead of "net" gain.

Also, this bill provides that a broker-dealer registered with the Securities and Exchange Commission or equivalent federal agency would not include its activities in the definition of liquid assets.

³ R&TC Section 25137

⁴ California Code of Regulations (CCR), title 18, Section 25137

Single Sales Factor

This bill would add a new R&TC Section 25128, and repeal the current R&TC Section 25128 as of January 1, 2008. The new R&TC Section 25128 would phase-in the single sales factor for qualified taxpayers and would allow certain taxpayers to elect to use the single sales factor. This bill would add the following provisions to the current rules on the apportionment of business income:

1. A “qualified taxpayer” would be required to apportion business income using a single sales factor. The single sales factor would be fully phased-in over three years. A qualified taxpayer is defined as an apportioning trade or business that derives more than 50 percent of its gross business receipts from conducting a business activity or combination of activities, described in specified Principal Business Activity Codes (PBACs). (See Appendix A.) In addition, sales arising from a treasury function of a taxpayer’s trade or business would not be included in the calculation of gross business receipts. Sales not included in the sales factor as gross receipts due to the application of Section 25137 would still be included as gross receipts in the calculation of the 50% threshold.

The qualified taxpayer may not use the single sales factor and must use the three-factor, double-weighted sales apportionment formula if its sales factor for the given year is less than the average of its payroll and property factors, and it fails to meet both of the following two employee tests:

- A. the average number of employees in the state during the taxable year must be at least 90 percent of the average number of employees it employed in this state during the preceding five taxable years, and
- B. the percentage decline in the number of employees in this state between the current and immediately preceding taxable year must be less than or equal to any corresponding, aggregate percentage decline with respect to the aggregate of all other states in which the qualified taxpayer reports wages.

If, due to a nonrecurring, nonnatural event, natural disaster, or other act of God, act of terrorism, or an act of federal, state, or local government the qualified taxpayer does not meet the employee tests, or the qualified taxpayer makes a capital investment in this state in the current taxable year of at least \$25 million, then the qualified taxpayer is not required to meet the “employee tests” and may use the single sales factor.

2. An apportioning trade or business that is not a qualified taxpayer may elect by contract to phase in the single sales factor or use the three-factor, single-weighted sales apportionment formula if the taxpayer derives more than 50 percent of its gross business receipts from conducting a business activity, or combination of activities described in specific PBACs. (See Appendix A). This is a one-time binding election that may be terminated due to an acquisition by a larger non-electing entity or by permission of the Franchise Tax Board.
3. An apportioning trade or business that is not a qualified taxpayer may elect to phase-in the single sales factor if the taxpayer derives more than \$1 billion of gross business receipts from conducting a business activity or a combination of activities described in specific PBACs. (See Appendix A.) This is a one-time binding election to be made by a taxpayer in the form and manner prescribed by the Franchise Tax Board. It is unclear whether the termination

methods stated above in number 2 are also available to taxpayers electing under this provision.

Other Apportionment Formulas

1. This bill would provide that an apportioning trade or business that derives more than 50 percent of its gross receipts from conducting a savings and loan activity or a banking or financial business activity, would use a three-factor, single-weighted sales apportionment formula. This is consistent with current state law.
2. This bill removes the requirement that an agricultural business activity or an extractive business activity will use a three-factor, single-weighted sales apportionment formula. This differs from current state law.
3. This bill provides that if an apportioning trade or business is neither a qualified taxpayer nor elects to phase-in the single sales factor or use a three-factor, single-weighted apportionment formula, then the taxpayer will use the three-factor, double-weighted sales apportionment formula.

This bill provides that if any portion of this section is held invalid, the other provisions of the section that can be reasonably separated shall be valid. Also, this bill provides that the rule that gross receipts arising from a treasury function would be limited to net gain, interest, and dividends would not apply to a broker-dealer registered with the Securities and Exchange Commission or equivalent federal agency.

This bill provides that it is the intent of the Legislature that provisions of the bill that revise the apportionment formulas are not intended to modify the sales factor portions of any special apportionment formulas found in regulations under section 25137.

Phase-In of Single Sales Factor

This bill would phase-in the single sales factor for qualified taxpayers and taxpayers that elect to use the single sales factor in the manner described below.

- For taxable years beginning on or after January 1, 2007, and before January 1, 2008, the taxpayer would use a three-factor, triple-weighted sales apportionment formula.
- For taxable years beginning on or after January 1, 2008, and before January 1, 2009, the taxpayer would use a three-factor, four and two-thirds weighted sales apportionment formula.
- For taxable years beginning on or after January 1, 2009, and before January 1, 2010, the taxpayer would use a three-factor, eight-weighted sales apportionment formula.
- For taxable years beginning on or after January 1, 2010, the taxpayer would use an apportionment formula consisting of a single-factor, 100 percent sales.

IMPLEMENTATION CONSIDERATIONS

1. The employee tests provided in this bill may be difficult for the department and taxpayers to verify as the tests include calculating employee statistics for prior years and for activities in other states.
2. The PBACs occasionally change. To ensure that just the targeted industries may use the single sales factor, the author may want to reference the PBACs as of a specified date.

TECHNICAL CONSIDERATIONS

1. The reference to "Section 38006" should be expanded to provide that it is located in Part 18. See attached Amendment 1.
2. The definition of the "treasury function" should be restored to the amendments in the bill as amended April 7 and 12, 2005. This would take care of issue number one found in the LEGAL IMPACT portion of this analysis. See attached Amendment 2.
3. To ensure that the amendments made by the bill include comprehensive definitions for treasury function activities, language should be added to include repurchase arrangements in the definition of a "liquid asset" since those transactions may be a significant activity of the treasury function. See attached Amendment 3.
4. The word "it" should be added to clarify the 90% employee test. See attached Amendment 4.
5. One of the binding elections found in the bill requires the election to be made by contract. This is not consistent with the other elections found in the bill, therefore, it is recommended the reference "shall be made by contract with the Franchise Tax Board" be deleted. See attached Amendment 5.
6. The word "required" is used to describe taxpayers subject to subdivisions (g) and (h) of the bill, but subdivision (g) is an election and not a requirement. It is recommended the word "required" be removed from subdivision (i). See attached Amendment 6.

LEGISLATIVE HISTORY

AB 2590 (Campbell, 2003/2004) and AB 2560 (Vargas, 2001/2002) would have replaced the three-factor, double-weighted sales apportionment formula used by most corporations with a single-factor apportionment formula based solely on sales and is similar to this bill. Exceptions to using the single-factor formula would have included: 1) taxpayers that had an average of property and payroll in California in excess of sales that did not meet certain employment requirements would use the three-factor, double-weighted sales formula, and 2) taxpayers that derive more than 50 percent of their gross business receipts from extractive activities could have used either the single-factor sales formula or the three-factor, single-weighted formula. AB 2590 and 2560 were held in Assembly Appropriations.

AB 1642 (Harmon, 2001/2002) and SB 1014 (Johnson, 2001/2002) would have changed the apportionment formula used to determine the amount of business income taxable by California to a single-factor apportionment formula based on sales, and allowed extractive businesses to choose either the current three-factor formula based on property, payroll, and sales, or use the new single-factor formula. AB 1642 died pursuant to Article IV, Section 10(c) of the Constitution and SB 1014 was returned to Secretary of Senate pursuant to Joint Rule 56.

OTHER STATES' INFORMATION

The states surveyed relating to using a single sales factor, include *Florida*, *Illinois*, *Massachusetts*, *Michigan*, *Minnesota*, and *New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws. Oregon and Wisconsin were also surveyed because these states recently began to phase-in a single sales factor.

Michigan and *Minnesota* have not adopted a single sales factor apportionment formula. *Florida* has adopted a single sales factor for citrus processing activities, and *Massachusetts* has adopted a single sales factor for manufacturers.

Illinois began using the single sales factor for tax years ending on or after December 31, 2000. The single sales factor was phased in as follows: 1) for tax year 1999, the apportionment formula was equal to 16 2/3 property factor, 16 2/3 payroll factor, and 66 2/3 sales factor, 2) for tax year 2000, the apportionment formula was equal to 8 1/3 property, 8 1/3 payroll, and 83 1/3 sales, and 3) for tax years beginning on or after December 31, 2000, the apportionment formula consisted of 100 percent sales. In general, the single sales factor formula is used by corporations deriving business income from the state, and not by a corporation's PBACs.

New York utilizes a business allocation formula to assign business income to *New York*. For tax year 2006, *New York* will begin the process of phasing in a new, single-factor allocation formula based on in-state receipts. The single-factor allocation formula will be phased-in as follows: 1) for tax year 2006, the business allocation formula will be equal to 20 percent property, 60 percent sales, and 20 percent payroll, 2) for tax year 2007, the business allocation formula will be equal to 10 percent property, 80 percent sales, and 10 percent payroll, and 3) for tax years beginning on or after January 1, 2008, the business allocation formula will consist of 100 percent sales.

For tax year 2006, *Wisconsin* will begin to phase-in a single-factor apportionment formula. The single-factor apportionment formula will be phased in as follows: 1) for tax year 2006, the apportionment formula will be equal to 20 percent property, 20 percent payroll, and 60 percent sales, 2) for tax year 2007, the apportionment formula will be equal to 10 percent property, 10 percent payroll, and 80 percent sales, and 3) for tax years beginning on or after December 31, 2007, the apportionment formula will consist of 100 percent sales. In general, the single sales formula will be used by corporations deriving business income from the state, and not determined by a corporation's PBACs.

For taxable years beginning on or after July 1, 2005, *Oregon* began using an apportionment formula for multi-state corporate income and excise taxpayers that consists of a 100 percent sales factor. Certain taxpayer's in the forest products industry may use a three factor, double-weighted sales apportionment formula consisting of 25 percent property, 25 percent payroll, and 50 percent sales. A corporation's PBAC does not effect whether a corporation may use the single sales apportionment formula.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

The estimated revenue impact of this bill is shown in the following table:

Estimated Revenue Impact of AB 1037 Assumed Enacted After June 30, 2006 Effective for tax years BOA Jan. 1, 2006 \$ Millions					
	2006-07	2007-08	2008-09	2009-10	2010-11
Treasury function	\$95	\$110	\$55	\$0	-\$105
Single sale factor	-\$5 Phase-In	-\$40 Phase-In	-\$85 Phase-In	-\$135 Phase-In	-\$190
Total	\$90	\$70	-\$30	-\$135	-\$295

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Treasury Function

The estimated revenue impact for the treasury function shown above differs from the revenue estimate included in the analysis of the bill as amended on April 7 and April 12, 2005, because of the following reasons:

1. the corporate profits growth rate used to project future revenues was updated,
2. the September 8, 2005, amendments added that income arising from a treasury function activity would always be classified as business income, and
3. the September 8, 2005, amendments added that a taxpayer's hedging activities relating to the business of the taxpayer would not be included in the definition of a treasury function activity.

It should be noted that the majority of the revenue impact relates to limiting gross receipts from a treasury function activity to net gains and reflects only a short-term cash flow gain. The reason for this is that the department assumes that its interpretation of the law relating to including "net gain" from treasury function activities in the sales factor is correct. Therefore, regardless of how taxpayers file, the use of gross receipts in the denominator of the sales factor for the treasury function will ultimately be disallowed. The impact of this bill would be to provide certainty and to accelerate the cash flow. This revenue would, under this bill, come into the state during the fiscal year when the taxpayer makes estimated and final payments, as opposed to several years later after an audit has been completed and the administrative dispute resolution process is final.

The revenue impact from the amendment that would reclassify all nonbusiness income from a treasury function activity to business income would result in a permanent revenue gain of approximately \$30 million each year. In addition, the amendment that removes hedging activities from the definition of a treasury function activity is estimated to result in short-term revenue losses as some taxpayers may take aggressive positions on reporting gross receipts from hedging activities. These positions are estimated to result in less revenue collected in the short-term, but collected in later years after an audit has been completed and the administrative dispute resolution process is final. It is estimated the short-term losses would be approximately -\$2 million in tax year 2006 and would grow to -\$12 million in 2010. It is assumed that the positive offset⁵ to the short-term revenue loss would happen two years after the revenue loss.

The revenue impact of the treasury function issue relating to gross receipts in the sales factor is estimated in three steps. Since the treasury function issue is associated mostly with large, apportioning out-of-state corporations, all corporations that met the following conditions for the 2001 tax year were identified:

1. taxable income greater than \$5 million,
2. headquarters outside of California,
3. income apportioned to California, and
4. gross receipts (as reported on line 1C of Schedule F, Computation of Net Income, Form 100) are less than 90% of gross sales (the denominator of the sales factor as reported on Schedule R, Apportionment and Allocation of Income, Form 100).

About 300 corporations met the above conditions. The preliminary revenue impact of the proposed law is estimated by re-computing the tax liability using the new apportioning factor in which the denominator of the sales factor is replaced with gross receipts. Next, the top 50 of these corporations were evaluated using the department's tax audit cases to identify the revenue impact due to treasury function issues for each corporation. Finally, the result of this evaluation was adjusted upward to account for the remaining 250 corporations, including the corporations that did not include Schedule F or Schedule R with their tax returns. The 2001 revenue estimate is extrapolated into future years based on the Department of Finance's projection of corporate profits.

For the treasury function business income issue, it is estimated that \$8.4 billion of the total \$17.5 billion of nonbusiness income reported on the 2003 California corporate tax returns relates to treasury function activities and would be reclassified as business income under the bill. An average apportionment percentage of 6.738 percent was applied to the \$8.4 billion of reclassified business income to arrive at additional California net income totaling \$566 million (\$8.4 billion times 6.738%). It was estimated that approximately \$190 million of the \$566 million of additional net income would have been California net income under current law because it was California nonbusiness income allocated 100% to California. Therefore, the additional nonbusiness income that would be reclassified as nonbusiness income under the bill would be \$376 million (\$566 million minus \$190 million). Assuming an average tax rate of 6 percent, the estimated 2003 revenue impact of reclassifying nonbusiness income to business income would be \$22.6 million. This number is then grown using the Department of Finance's projections, to approximately \$30 million for tax year 2006.

⁵ after an audit is completed and the administrative dispute resolution process is final.

For the treasury function hedging activities issue, the estimated short-term revenue losses are estimated based on discussions with the department's audit and legal staff regarding actual cases.

Single Sales Factor

The estimated revenue impact from the single sales factor amendment in the table above shows the three-year phase-in of the single sales factor beginning January 1, 2007, and ending for tax years beginning on or after January 1, 2010, when certain taxpayers may begin to use the single sales factor apportionment formula.

For the single sales factor apportionment formula issue, samples of corporate tax returns for the tax years 2001, 2002, and 2003 were used for this analysis. For each corporation, tax liabilities under current and the proposed apportionment formulas were computed. The revenue impact was estimated as the difference between the computed tax liabilities. The impact for each individual corporation was then statistically weighted and aggregated to derive an estimate of the total revenue impact for each of the above sampled tax years. The revenue impact was computed as the average of these three tax years. The estimated impact is assumed to grow at the same growth rate as corporate profits for future years.

The proposed single sales factor apportionment formula would increase the tax liability of some taxpayers, and decrease the tax liability of others. Since the tax decreases are estimated to be substantially more than the tax increases, the bill would result in ongoing tax revenue losses.

LEGAL IMPACT

1. This bill would treat all treasury function income as business income subject to California tax. If the treasury function income has no relationship to activities that occur in the state, this rule may be determined to violate the Commerce Clause of the Constitution. Taxpayers may argue that the Commerce Clause is violated because inclusion of the treasury function in business income is not rationally related to activities that take place in the state.
2. This bill excludes a taxpayer's hedging activities such as the purchase and sale of futures contracts relating to business activities from the definition of the treasury function. This may allow taxpayers to decrease their California sales factor by including the gross receipts from these activities in the sales factor denominator.
3. There may be constitutional issues with this bill since it prefaces whether a taxpayer may use the single sales factor on the level of activity in this state. Possible constitutional issues are found twice in the bill; first in the employee tests⁶ and second where the taxpayer may use the single sales factor if it invests \$25 million⁷ in the state.

LEGISLATIVE STAFF CONTACT

Gail Hall
Franchise Tax Board
(916) 845-6111
gail.hall@ftb.ca.gov

Brian Putler
Franchise Tax Board
(916) 845-6333
brian.putler@ftb.ca.gov

⁶ On page 8, line 24, of the bill as amended September 8, 2005.

⁷ On page 9, line 17, of the bill as amended September 8, 2005.

Analyst: Gail Hall
Telephone#: 845-6111
Attorney: Patrick Kusiak

FRANCHISE TAX BOARD
PROPOSED AMENDMENTS TO AB 1037
As Amended September 8, 2005

AMENDMENT 1

On page 3, line 28, after "38006," insert:
of Part 18 (commencing with Section 38001),

AMENDMENT 2

On page 3, line 38, after "assets" insert:
for the purpose of satisfying the cash flow needs of the trade or
business, including, but not limited to, providing a reserve for business
contingencies and business acquisitions

AMENDMENT 3

On page 4, revise lines 5 through 8 to read as follows:
(ii) "Liquid asset" means a readily marketable intangible,
including, but not limited to, bonds, stocks, futures contracts,
debentures, options, warrants, foreign currency, ~~and~~ mutual funds that
hold those intangibles, and repurchase arrangements relating to such
intangibles.

AMENDMENT 4

On page 8, line 33, after "employees" insert:
"it"

AMENDMENT 5

On page 9, line 36, strikeout "by contract with the Franchise
Tax Board"

AMENDMENT 6

On page 10, line 17, strikeout "required to apportion" and
insert:
"apportions"

APPENDIX A
(Principal Business Activity Codes Used In AB 1037)

1. QUALIFIED TAXPAYER

Code	Description
325410	Pharmaceutical & Medicine Mfg
333295	Semiconductor Machinery Mfg
334110	Computer & Peripheral Equipment Mfg
334200	Communications Equipment Mfg
334410	Semiconductor & Other Electronic Component Mfg
339110	Medical Equipment & Supplies Mfg
511210	Software Publishers
512100	Motion Picture & Video Industries (except video rental)
515100	Radio & Television Broadcasting
515210	Cable & Other Subscription Programming
517510	Cable and Other Program Distribution
541519	Other Computer Related Services
713100	Amusement Parks & Arcades

2. MORE THAN \$1 BILLION OF GROSS BUSINESS RECEIPTS

Code	Description
512100	Motion Picture & Video Industries (except video rental)
515100	Radio & Television Broadcasting
515210	Cable & Other Subscription Programming
517510	Cable and Other Program Distribution
713100	Amusement Parks & Arcades

3. MORE THAN 50% OF GROSS BUSINESS RECEIPTS

Code	Description
211110	Oil & Gas Extraction
221210	Natural Gas Distribution
324110	Petroleum Refineries (including integrated)
324190	Other Petroleum & Coal Products Mfg
424700	Petroleum & Petroleum Products
425120	Wholesale Trade Agents & Brokers
447100	Gasoline Stations (including convenience stores w/gas)
454312	Liquefied Petroleum Gas (Bottle Gas) Dealers
486000	Pipeline Transportation
523130	Commodity Contracts Dealing